

DEPARTMENT OF STATE REVENUE

LETTER OF FINDINGS NUMBER: 96-0644 ST

Sales/Use Tax — Manufacturing Exemption

Sales/Use Tax — Items Assessed in Error

Tax Administration — Penalty

For Tax Periods: 1993 through 1995

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ISSUES

I. Sales/Use Tax — Manufacturing Exemption

Authority: IC 6-2.5-5-3(b); IC 6-2.5-5-5.1(b)
45 IAC 2.2-5-12(f); 45 IAC 2.2-5-8(h)(1)

Taxpayer protests the assessment of Indiana use tax on its purchase and use of acetone and mask cleaning equipment.

II. Sales/Use Tax — Items Assessed in Error

Taxpayer protests the assessment of Indiana use tax on certain fixed assets purchased and used at out-of-state facilities.

III. Tax Administration — Penalty

Authority: IC 6-8-10-2.1
45 IAC 15-11-2; 45 IAC 2.2-3-20

Taxpayer protests the imposition of a ten-percent (10%) negligence penalty.

STATEMENT OF FACTS

Taxpayer operates a manufacturing facility in Indiana. Among other products, taxpayer produces plastic front-end grills for the automotive industry. Taxpayer's manufacturing operation is comprised of several distinct processes. As a first step, injection-molding equipment is used to transform raw plastic pellets into molded vehicle grills. Next, taxpayer, through electroplating, applies chrome to specific areas of the grill. The grill is then painted. However, before the paint can be applied, a reusable paint mask must be attached to the grill to protect chrome-plated areas from any paint overspray. After painting, the reusable paint mask must be removed and cleaned - in either an acetone bath or "solventless" mask washer. Taxpayer contends that its purchase of the acetone and the "solventless" mask washer should have been exempt from Indiana sales and use tax.

I. Sales/Use Tax — Manufacturing Exemption

DISCUSSION

Taxpayer protests the assessment of Indiana use tax on its purchases of the acetone and the "solventless" mask washing equipment. Taxpayer argues that the items should have been exempt because they are "essential and integral" to its "integrated production process." Specifically, taxpayer invokes the equipment exemption, IC § 6-2.5-5-3, and the consumption exemption, IC § 6-2.5-5-5.1.

Audit has denied these exemptions on two grounds. Audit has determined that the acetone is taxable under 45 IAC 2.2-5-12(f) which imposes a tax on materials that are consumed in the maintenance of production and non-production equipment.

45 IAC 2.2-5-12(f) states in part:

Purchases of materials consumed in manufacturing, processing, refining, or mining activities beyond the scope of those described in ... [*subsection (e) of this section*] are taxable.

Audit has also denied taxpayer an exemption for the "solventless" mask washing equipment. Audit has determined that this equipment is taxable because it is predominantly used to *maintain* production machinery – i.e., the paint masks.

45 IAC 2.2-5-8(h)(1) reads:

Machinery, tools, and equipment used in the normal repair and maintenance of machinery used in the production process which are predominantly used to maintain production machinery are subject to tax.

Taxpayer, in response, concedes that within its integrated production process a piece of equipment is being cleaned. Taxpayer also acknowledges that acetone, commonly known as an industrial solvent, is primarily used for industrial cleaning - and such use is taxable. However,

taxpayer believes that for its particular use, such a characterization would be inaccurate. The cleaning of the paint masks, taxpayer argues, is a necessary step in its manufacturing process. Taxpayer reasons that since the acetone and the mask washing equipment are used in a necessary production step, both should be exempt from tax - the acetone as an item *consumed* during its manufacturing process, the "solventless" mask washing equipment as machinery used directly in the direct manufacture of its products. For taxpayer, the acetone and the "solventless" mask washing equipment are "*essential and integral*" to its integrated production process.

Taxpayer notes that its integrated production process starts well before the molded chrome-plated plastic grills are prepared for painting. In fact, painting is just one element in taxpayer's multi-step manufacturing process. The process begins with small plastic pellets being transformed into molded front-end grills through high-pressure injection molding. The grills are then moved to an electroplating area. There, chrome is applied to specific grill areas according to its customers' detailed specifications. The chrome-plated grills are then transported to a painting area.

In its description of the painting process, taxpayer states that the "[p]ainting [of] the molded grill is performed by an individual in a series of integrated and related steps." Taxpayer explains that before any paint can be applied, a protective mask must be placed over the grill in order to protect the chrome-plated areas. The grill, which has been placed on a moveable stand, rotates in front of a mechanical robot. The mechanical robot, spraying paint indiscriminately, applies paint to both the front and back of the grill, as well as to the protective mask. When the painting has been completed, the protective mask is removed from the newly painted grill and placed in either an acetone or "solventless" mask washer. A new unpainted grill is then placed on the moveable stand. And the process repeats.

Taxpayer emphasizes that the protective masks must be clean *before each* chrome-plated grill can be painted. Any paint build up on the mask would cause it to acquire an irregular edge. An irregular edge would cause the mask to fit improperly. An improper fit would allow paint to reach chrome-plated areas. The result would be an unsaleable product. Taxpayer argues that it is only through its use of acetone and mask-washing equipment that the reusable paint masks can be kept clean. Such use, taxpayer concludes, makes "[t]he mask washers, including the acetone fluid ... an essential part of the integrated manufacturing process used to produce painted, electroplated automotive trim components."

In Indiana, an excise tax (sales tax) is imposed on retail transactions. A complementary excise tax (use tax) is imposed on tangible personal property that is stored, used, or consumed in this state. Several exemptions from these taxes are available. Taxpayer, in this instance, relies on two of the industrial exemptions.

Referred to as the equipment exemption, IC § 6-2.5-5-3(b) reads:

Transactions involving manufacturing machinery, tools and equipment are exempt from the state gross retail tax [sales tax] if the person acquiring that property acquires it for *direct use in the direct production*, manufacture,

fabrication, assembly, extraction, processing, refining, or finishing of other tangible personal property.

The consumption exemption, IC § 6-2.5-5-5.1(b), reads in part:

Transactions involving tangible personal property are exempt from the state gross retail tax if the person acquiring the property acquires it for *direct consumption as a material to be consumed in the direct production* of other tangible personal property in the person's business of manufacturing, processing, refining, repairing....

The equipment and consumption statutes upon which taxpayer relies share similar wording and construction. Both statutes contain the "double direct" language - language which describes a standard that can be met when a particular item is determined to be "essential and integral" to taxpayer's "integrated production process." *Indiana Department of State Revenue v. Cave Stone, Inc.*, 457 N.E.2d 520 (Ind. 1983).

The Department believes that taxpayer's cleaning activities are similar to those routine maintenance activities that are required for all types of production equipment; and such use is never exempt from taxation. The Department considers taxpayer's cleaning of paint masks to be a function of maintenance, regardless of when performed - whether prior to the first production run of the day, or between production runs, or between work shifts, or between tasks, or at the end of the workday. While the acetone and mask washing equipment directly affect the cleaning and maintenance of the protective paint masks, and may be "essential and integral" to their upkeep, such use is ultimately ancillary to taxpayer's production of front-end grills. The cleaning activities, therefore, are not "essential and integral" to taxpayer's manufacture of front-end grills.

Consequently, consistent with 45 IAC 2.2-5-8(h)(1) and 45 IAC 2.2-5-12(f), the acetone and the mask washing equipment are not exempt from Indiana sales and use tax.

FINDING

Because the Department finds the cleaning of the protective paint masks to be a part of taxpayer's routine maintenance activities, taxpayer's protest is denied.

II. Sales/Use Tax — Items Assessed in Error

DISCUSSION

Taxpayer protests the assessment of Indiana use tax on fixed assets purchased and used out-of-state.

In addition to keeping the proper documentation of its own purchases, taxpayer also kept documentation of purchases made by an out-of-state subsidiary. During the audit, the auditor had to segregate a large number of purchase orders and receipts. Two were missed. Taxpayer

has provided evidence showing that two items purchased and used by its out-of-state subsidiary were erroneously included in this assessment.

FINDING

The taxpayer's protest is sustained. The Department finds that the two items purchased and used at taxpayer's subsidiary's out-of-state location should be excluded from this assessment.

III. Tax Administration — Penalty

DISCUSSION

The taxpayer protests the imposition of the ten-percent (10%) penalty. The negligence penalty imposed under IC 6-8.1-10-2.1(e) may be waived by the Department where reasonable cause for the deficiency has been shown by the taxpayer. Specifically:

The department shall waive the negligence penalty imposed under IC 6-8.1-10-2.1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section. 45 IAC 15-11-2(e).

Taxpayer, in response to an assessment in a prior audit, was unsuccessful in its protest of this issue. Consequently, at this time, application of the negligence penalty is appropriate.

FINDING

The taxpayer's protest is denied.